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No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF *AMICUS CURIAE* SECURITIES INDUSTRY ASSOCIATION, INC. IN SUPPORT OF PETITIONERS

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BRIEF OF *AMICUS CURIAE* SECURITIES INDUSTRY ASSOCIATION, INC. IN SUPPORT OF PETITIONERS

STATEMENT OF INTEREST OF *AMICUS CURIAE*[1]

Securities Industry Association, Inc. ("SIA") is a trade association of approximately 700 securities firms in the United States and Canada that collectively account for approximately 90 percent of the securities business conducted in North America. SIA's members provide a wide variety of professional services to investors and others, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, money management and investment advisory services.

The summary order below ordered a remand in light of *Pacific Dunlop Holdings Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), *cert. dismissed*, 114 S. Ct. 1146 (1994). The Seventh Circuit's opinion in *Pacific Dunlop* – which held that Section 12(2) of the Securities Act of 1933 is not limited to initial distributions of securities to the public and determined that liability under that section extended to a private sale of stock – presents a matter of enormous concern to SIA and its members. In light of the relatively modest showing required of a plaintiff under Section 12(2) and the powerful remedy of rescission provided thereunder, this unjustifiably broad interpretation of Section 12(2), if upheld, would impose untenable risks of liability on SIA's members for such ordinary activities as providing investors with research reports containing updated information regarding companies. The *Pacific Dunlop* holding would therefore directly affect the manner in which the members of SIA routinely have done business in the past and would restrict the flow of crucial information to the investing public.

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[1] This brief is filed with the written consent of the parties pursuant to Rule 37.3 of the Rules of this Court. The parties' consent letters have been filed with the Clerk of this Court.

SUMMARY OF ARGUMENT

Congress passed the Securities Act of 1933 (the "1933 Act") to combat perceived abuses in connection with initial distributions of securities to the investing public[2] by mandating the disclosure of detailed information to investors. Section 12(2) was enacted as part of that statutory framework and specifically imposed civil liability on sellers of securities for misrepresentations or omissions in "a prospectus or oral communication." As such, Section 12(2) clearly applies to initial distributions of securities to the investing public. Just as clearly, however, Section 12(2) does *not* apply to secondary market transactions or private sales of securities such as that at issue in the decision below.

The limitation of Section 12(2) to initial distributions of securities is mandated by its plain language, statutory context and legislative history, as well as by critical policy considerations. First, the language of Section 12(2) on its face cannot sensibly be construed to apply to transactions other than initial distributions of securities. Second, when considered as part of the statutory structure established by Congress in the 1933 Act and the Securities Exchange Act of 1934 (the "1934 Act"), it is apparent that the scope of Section 12(2) is limited to initial distributions. Third, the legislative history surrounding the enactment of the 1933 Act reflects Congress's intent to limit the application of Section 12(2) to initial distributions.

Finally, and of particular significance to SIA and its members, critical policy considerations – including the need for the rapid dissemination of information necessary for the efficient operation of capital markets – dictate that Section 12(2) be kept in its rightful place and limited to initial distributions. Imposing the relaxed liability standard and

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[2] The term "initial distribution of securities" is used herein to refer both to initial public offerings and subsequent public offerings by an issuer.

onerous remedies[3] of Section 12(2) on securities firms for their research reports and other post-distribution communications with their customers and other investors will drastically inhibit the flow of information to the investing public. Such a result would be entirely at odds with the goals of the 1933 Congress which sought to provide the investing public with greater access to information regarding securities and the companies that issued them.

This Court should reverse the decision below and hold that the application of Section 12(2) is limited to initial distributions of securities.

ARGUMENT

The central issue in this case is the scope of the term "prospectus" as used in Section 12(2) of the 1933 Act. Section 12(2) imposes civil liability on any seller offering or

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[3] In examining the policy considerations relevant to the interpretation of Section 12(2), this Court should bear in mind that, compared to Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1988), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1993), Section 12(2) requires a lesser showing of culpability and provides for a broader measure of damages.

A party asserting a claim under Rule 10b-5 is required to establish, among other things, both (i) "scienter" or intent to deceive, manipulate or defraud; and (ii) justifiable reliance upon the alleged misrepresentation or omission. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) ("scienter" requirement); *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (reliance requirement). By contrast, Section 12(2) allows recovery for negligent conduct, *Hochfelder*, 425 U.S. at 208, and does not require a showing of reliance by the plaintiff. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 692 (3d Cir.), *cert. denied*, 112 S.Ct. 79 (1991). Indeed, in stark contrast to Rule 10b-5, Section 12(2) imposes a burden on the defendant of showing that it was not negligent with respect to the alleged misrepresentation or omission.

In addition, Section 12(2) provides for a remedy that is "the substantial equivalent of rescission." *Pinter v. Dahl*, 486 U.S. 622, 641 n.18 (1988). Rule 10b-5, however, permits recovery only of actual damages. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972).

selling a security "by means of a prospectus or oral communication" that contains an untrue statement of material fact or omits to state a necessary material fact. 15 U.S.C. § 77l (1988).[4] Respondents urge an interpretation of "prospectus" which effectively extracts all meaning from the word by interpreting it as any writing relating to the sale of a security. However, a close reading of the language of the 1933 Act, coupled with an analysis of its structure and legislative history, compels a conclusion that "prospectus" refers to writings associated with the public distribution of newly issued securities, a conclusion fully supported by 60 years of efficient functioning of this country's capital markets.

I. THE PLAIN LANGUAGE OF THE 1933 ACT LIMITS THE APPLICATION OF SECTION 12(2) TO INITIAL DISTRIBUTIONS OF SECURITIES.

Congress employed the term "prospectus" in several sections of the 1933 Act. "Prospectus" had a common and well-understood meaning at the time the 1933 Act was enacted, and was frequently used in the congressional debates when the 1933 Act was being considered. 77 Cong. Rec. 2910-55 (1933).[5]

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[4] The text of Section 12(2) is set out in the appendix to this brief.

[5] For example, Rep. Rayburn of Texas, citing the need to impose upon officers of corporations issuing stocks a duty to the purchasers, stated: "The prospectus or advertisement of the security, if it is more than a mere announcement of the name and price of the issue offered, must include any part of the matter contained in the registration statement which the Commission, in its discretion, may require." 77 Cong. Rec. 2918-19 (1933).

Rep. Lambeth of North Carolina stated: "This bill strikes hard at practices which have robbed countless investors of their savings. Interstate and foreign commerce is barred against new securities until registration statements have been on file with the Federal Trade Commission 30 days. At any time thereafter the Commission may issue a 'stop' order for sufficient cause. Every prospectus, by radio or otherwise, must contain the essential parts of the statement." *Id.* at 2948.

See also statements by Rep. Mapes of Michigan at 2912, Rep. Cox at 2920 and 2938, Rep. Parker of New York at 2922 and 2923, Rep. Breedy of

As its Latin root suggests,[6] the term referred to the plan, proposal or "prospects" for a new or expanding enterprise. At the time the 1933 Act was considered, a prospectus was commonly understood to be a document describing a new issue of securities to the public. Contemporary reference works[7] defined a "prospectus" to be:

> A typewritten or printed plan of organization of a new enterprise, or for the expansion of an existing enterprise, usually prepared by the promoters and their associates for the purpose of interesting financiers in the purchase of the securities.

G. Munn, *Encyclopedia of Banking and Finance* at 471 (1924).[8]

Maine at 2953, and Rep. Black of New York at 2954. Reps. Rayburn, Parker and Mapes were all members of the House subcommittee charged with drafting the House bill. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 38 n.16 (1959). Rep. Rayburn chaired both the House Committee on Interstate and Foreign Commerce and the conference committee which reconciled the Senate and House bills. *Id.* at 31, 45.

[6] Prospectus derives from "prospectus," the past participle of the Latin "prospicere," which means to look forward, or exercise foresight. *Webster's Ninth New Collegiate Dictionary* at 945 (1990).

[7] This Court relied on contemporary reference works to construe terms in the 1934 Act in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 198-99 (1976). The Court described this exercise as important to prevent a construction that adds "a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Id.* In construing the terms "manipulative or deceptive" and "device or contrivance" under Section 10(b) of the 1934 Act, the Court relied on *Webster's New Int'l Dictionary of the English Language* (2d ed. 1934).

[8] Other contemporary reference works contained the following definitions of "prospectus":

> A preliminary statement, usually printed, issued by promoters of an enterprise, the publishers of a literary work, the administration of a private school or college, or the like, giving advance information calculated to arouse interest and win support; *specif., an exposition of the conditions of*

Beyond selecting "prospectus" to use throughout the 1933 Act, Congress also used "prospectus" as the first word in the term's own definition. The 1933 Act, as amended, defines "prospectus" as follows:

> any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . .

15 U.S.C. § 77b(10) (1988).[9]

Congress's utilization of prospectus in the word's own definition was not an inadvertent drafting error. Rather, Congress selected this precise term because it had a commonly understood, readily identifiable meaning in connection with the issuance of securities.

Congress's use of the distinct term "prospectus" in the word's own definition also placed the words that immediately follow it into a definitional context. In addition to defining a "prospectus" as a "prospectus," Congress added the specific

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> *incorporation and the financial prospects of a business undertaking.*

Webster's New Int'l Dictionary of the English Language at 1988 (2d ed. 1934) (emphasis added).

> A document published by a company or corporation, or by persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares, debentures, or other securities created by the company or corporation, and inviting the public to subscribe to the issue.

H. Black, *A Law Dictionary* at 959 (2d ed. 1910).

> [T]he name for a notice calling the attention of the public to the issue of any stock or shares, or debentures or other securities. It is generally accompanied by a form of application for the use of persons who are willing to subscribe, and gives particulars as to the amount issued, the security offered, and other matters which intending subscribers may wish to know.

III *Dictionary of Political Economy* at 233 (1918). *See also* III *Palgrave's Dictionary of Political Economy* at 233 (1926).

[9] Among the amendments to the 1933 Act, Congress added the terms "or television" and "or confirms the sale of any security" in 1954. Act of Aug. 10, 1954, ch. 667, Title I, § 3, 68 Stat. 683 (1954).

terms "notice, circular, advertisement, letter, or communication, written or by radio or television." These additional terms were synonymous with or related to "prospectus"[10] and were added to embellish the distinct word prospectus, ensuring that prospectus-like writings did not escape regulation simply because they could be characterized as something else.[11]

The definitional listing in Section 2(10) should be interpreted using traditional rules of statutory construction, which dictate that "words grouped in a list should be given related meaning." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 218 (1984) (quoting *Third Nat'l Bank v. Impac, Ltd.*, 432 U.S. 312, 322 (1977)).[12]

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[10] The *Encyclopedia of Banking and Finance* notes that a prospectus is issued to the underwriters or financiers, while a "circular" is distributed to the public, "although to some extent, these terms are used synonymously." G. Munn, *Encyclopedia of Banking and Finance* at 471 (1924).

In the House debate on the 1933 Act, Rep. Rayburn referred to "a prospectus or advertisement of the security." 77 Cong. Rec. 2919 (1933). Rep. Lambeth referred to "[e]very prospectus, by radio or otherwise." *Id.* at 2948.

[11] The importance of using such other synonymous terms is exemplified by the registration provisions of the 1933 Act. Section 5(c), 15 U.S.C. § 77e(c) (1988), bars the use of any selling communications prior to the filing of a registration statement. During the time period after the registration has been filed but before it becomes effective (the "waiting period"), Section 5(b)(1), 15 U.S.C. § 77e(b)(1) (1988), bars the use of any "prospectus" to offer or sell a security except a preliminary prospectus meeting the requirements of Section 10, 15 U.S.C. § 77j (1988). The definition in Section 2(10) gives substance to this limitation by ensuring that issuers do not evade this prohibition by using other prospectus-like writings to offer securities for sale. Therefore, by reading Section 2(10) in conjunction with Section 5(b)(1), Congress effectively prohibited the use of written selling materials – except preliminary prospectuses – during the waiting period. *See generally* Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Lawyer 1, 9-12 (1992).

[12] *See also Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961) ("The maxim noscitur a sociis, that a word is known by the company it

This Court used that analytical approach in *Securities Industry Association* to consider whether the acquisition of a retail securities broker by a bank holding company violated Section 20 of the Glass-Steagall Act, 12 U.S.C. § 377 (1988). Section 20 barred member banks from affiliating with entities engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities. *Id.* at 216. While the brokerage company undoubtedly was engaged principally in the "public sale" of securities, this Court noted that the words grouped together should be given related meaning, and, therefore, read "public sale" in context with the underwriting activity described by the terms elsewhere in the list to conclude that the acquisition did not violate Section 20. *Id.* at 218, 221.

Similarly, the terms following "prospectus" in Section 2(10) must be read in light of the terms with which they are associated. Specifically, the words in Section 2(10) must be read as referring not to *any* "communication," for example, but to a specific type of communication. This communication – identified and given context by the word prospectus – refers to the written transmission of information offering an issue of securities to the public.

The Seventh Circuit in *Pacific Dunlop*, 993 F.2d at 588, read the Section 2(10) definition of "prospectus" as referring to *any* written communication. As a result, *any* document connected with the sale of a security qualifies as a "prospectus". Such a myopic reading, focusing on one or two words of the definition to the exclusion of the remainder, should be rejected because it ignores the remaining definitional language in Section 2(10). After all, reciting a list of defined terms and then concluding the list with the catchall of "other communication" is pointless unless the terms are read in light of one another and in light of the point that is being made. The full context of the definition of "prospectus"

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keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress.").

shows that Congress had in mind writings associated with the public sale of new issues.

Moreover, the interpretation of the *Pacific Dunlop* court ignores the "by means of a prospectus or oral communication" language of Section 12(2). Congress specifically used the term "prospectus or oral communication" in Section 12(2) as a limitation. Even the *Pacific Dunlop* court concedes that "oral communication" in Section 12(2) refers not to any oral communication but only to an oral communication made in connection with a written prospectus. *Pacific Dunlop*, 993 F.2d at 588. *See also Ballay*, 925 F.2d at 688. Yet, defining "prospectus" as any communication reads out any limiting language used by Congress by making any written or oral communication actionable. If Congress had intended *any* oral or written communication to be actionable under Section 12(2), it could directly have used the more appropriate language "any written or oral communication" or even more concisely "any communication" in Section 12(2). *See Reves v. Ernst & Young*, 113 S. Ct. 1163, 1169 (1993) (explaining that Congress's definitions should not be read so as to make words superfluous.)

II. THE STATUTORY CONTEXT OF SECTION 12(2) LIMITS ITS APPLICATION TO INITIAL DISTRIBUTIONS OF SECURITIES.

The structure of the 1933 Act indicates Congress's intent to restrict Section 12(2) to initial offerings of securities to the public. Section 12(2) follows Sections 11 and 12(1), and immediately precedes Section 13. Section 11 imposes civil liability for false statements in registration statements and Section 12(1) imposes civil liability for the sale of unregistered securities – violations that arise in the course of initial offerings. Section 13 establishes the statute of limitations for civil actions brought under Sections 11 and 12. *See Ballay*, 925 F.2d at 691.

Section 12(2) rounds out this initial distribution civil liability scheme by imposing liability in connection with misstatements made pursuant to a prospectus or related oral communication. Thus, the provisions of Sections 11, 12(1)

and 12(2) together cover the universe of possibilities in an initial distribution – failure to register, misstatements or omissions in registration, and misstatements or omissions in public offerings.

Section 12(2)'s placement in conjunction with Section 12(1) is particularly telling. Section 12(1) unambiguously concerns only initial distributions of securities. Had Congress intended a broader scope for Section 12(2), it would wisely have established Section 12(2) as a completely separate provision or, at a minimum, explained Section 12(2)'s wider applicability. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230, 4233 (U.S. April 19, 1994) (explaining that "Congress knew how to impose . . . liability when it chose to do so.")

Yet, the *Pacific Dunlop* interpretation creates the oddity of finding a broad remedy under Section 12(2) in the midst of a closely woven pattern of regulatory sections concerned exclusively with the initial offerings of securities. This interpretation is particularly puzzling in light of the fact that there is no indication anywhere that Congress intended Section 12(2) to have broader applicability than the surrounding provisions of Sections 11, 12(1) and 13.

On the other hand, Congress specifically did so indicate when it created a broad remedial provision in Section 17, 15 U.S.C. § 77q (1988), which provides criminal penalties and other governmental enforcement mechanisms for both initial and secondary market transactions. *See United States v. Naftalin*, 441 U.S. 768, 777-78 (1979). The language of Sections 17 and 12(2), while similar in some respects, differs markedly on the essential point of liability. Section 12(2) limits liability to communications made "by means of a prospectus or oral communication." Section 17, conversely, imposes liability for conduct "directly or indirectly" that "employ[s] any device" to defraud, or to obtain money through "any untrue statement" or "any omission."[13] The

[13] The text of Section 17 is set out in the appendix to this brief.

language of Section 17 has no limitation corresponding to that found in Section 12(2).

Sections 17 and 12(2) have distinct purposes – government enforcement versus private causes of action. Sections 17 and 12(2) have distinct language – broad versus narrow. And Sections 17 and 12(2) have distinct standards of culpability – fraud versus negligence. As such, it is disingenuous to argue that Congress intended these two sections to have identical applications.

Moreover, the Court has recognized Congress's intent that Section 17 be unique. As noted by this Court in *Naftalin*:

> Although it is true that the 1933 Act was primarily concerned with the regulation of new offerings, respondent's argument fails because the antifraud prohibition of § 17(a) was meant as a major departure from that limitation. Unlike much of the rest of the Act, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary secondary market trading.

Naftalin, 441 U.S. at 777-78. This Court's conclusion was based upon the legislative history of Section 17, including the Senate report, which provided:

> The act subjects the sale of *old or outstanding securities* to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation *as in the case of new issues put out after the approval of the act*. In other words, fraud or deception in the sale of securities may be prosecuted *regardless of whether the security is old or new*, or whether or not it is of the class of securities exempted under sections 11 or 12.

Id. at 778 (quoting S. Rep. No. 47, 73d Cong., 1st Sess., 4 (1933) (emphasis added)). No corresponding "major departure" from the 1933 Act's focus on initial distributions is found with respect to Section 12(2) in the language, context or legislative history of the 1933 Act.

The 1933 Act must also be read in light of the subsequent regulatory scheme put in place under the 1934 Act. The 1934 Act was principally intended to protect investors against

manipulation of publicly traded securities by regulating transactions on securities exchanges, and to impose regular reporting requirements on companies whose stock is listed on the exchanges. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The extensive disclosure requirements of the 1934 Act implemented a philosophy of "full disclosure." *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988).

The rules of the Securities and Exchange Commission (the "SEC"), in total, provide an array of reporting requirements to keep investors current on the financial status of companies whose securities trade publicly.[14] In view of the purpose of the 1934 Act and its stringent reporting requirements, it is discordant, at best, to suggest that Congress placed a broad remedial remedy for post-registration misstatements or omissions in the 1933 Act, while it did not impose the post-registration disclosure requirements until the 1934 Act.

Finally, several unique characteristics of Section 12(2) are only explainable by an interpretation restricting that section to initial distributions. First, the remedies under Section 12(2) apply only to buyers. If Congress's intent was to combat all negligent misrepresentations in both initial distributions and secondary market transactions, it logically would have applied Section 12(2) to both buyers and sellers, as it did with Section 10 of the 1934 Act. Recognizing Congress's understanding and intent that Section 12(2) would be limited to initial distributions, however, explains why its remedies were applied only to buyers. A buyer in an initial distribution of securities is in no position to make misstatements of fact to the sellers, so any remedies granted to sellers under Section 12(2) would be superfluous.

[14] The 1934 Act authorized the SEC to issue rules delineating these reporting requirements. 15 U.S.C. § 78m. Among the reports required to be filed are an annual Form 10-K report, a quarterly Form 10-Q report, and Form 8-K report with respect to certain specified events. *See* SEC Rule 13a, 17 C.F.R. Ch. 2 §§ 13a-1 *et seq.* (1993).

Second, the rescissionary measure of damages under Section 12(2) is an equitable remedy only when sellers are engaged in an initial distribution. In an initial distribution, the seller receives the full consideration paid by the buyer and the rescissionary measure of damages makes sense as an appropriate remedy. In secondary market transactions, a "seller" such as a broker or other professional advisor may receive only a relatively small fee for its services. *Ballay*, 925 F.2d at 693. It would be unjustifiably punitive to force such a seller – who never receives the consideration in the first place – to pay back a rescissionary measure of damages for a negligently made error.

Third, the rescissionary measure of damages and the limiting of remedies to buyers make sense only in the context of initial distributions because those distributions are one-party agreements. That is, the issuer and its underwriters formulate the terms of the sale and the issuer provides all the information that the public will receive in the prospectus. *See Ballay*, 925 F.2d at 693. A private stock purchase agreement – like the contract at issue in this case – is a two-party agreement. Both sides to the agreement negotiate the terms of the agreement, the information provided therein, and the warranties and other allocations of risk within the sale. It would be anomalous to provide a remedy exclusively to one party to such a two-sided transaction.

III. THE LEGISLATIVE HISTORY OF THE 1933 ACT DEMONSTRATES CONGRESS'S INTENT TO RESTRICT SECTION 12(2) TO INITIAL DISTRIBUTIONS OF SECURITIES.

The 1933 Act primarily was concerned with the regulation of new public offerings of securities. *See Central Bank of Denver, N.A.*, 62 U.S.L.W. at 4232 ("The 1933 Act regulates initial distributions of securities . . . . "); *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979). As Congress considered the 1933 Act, it was well known that a separate act would be forthcoming to regulate secondary market transactions. Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent*

Legislative Materials, 15 Fordham Urb. L.J. 877, 906 (1987). While the scope of the 1933 Act is not limited exclusively to initial offerings, "[n]othing in the legislative history or structure of the 1933 Act indicates that Congress intended to broaden section 12(2) beyond the 1933 Act's principal purpose of regulating the distribution of new offerings." *Ballay*, 925 F.2d at 690.

President Franklin D. Roosevelt urged Congress on March 29, 1933, to create a mechanism to provide the investing public with full information regarding newly issued securities.[15] Both houses of Congress responded with bills that would regulate the issuance of new securities to the public. The House bill, which provided the framework of the 1933 Act, specifically limited the application of Section 12(2) to initial distributions.[16] In its general analysis of the entire bill, the House Report said:

> The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issue possessed by those responsible for the offering.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

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[15] President Roosevelt stated:

> There is, however, an obligation upon us to insist that *every issue of new securities to be sold in interstate commerce* shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933) (emphasis added).

[16] James M. Landis, a key drafter of the House bill, described the draft bill as follows: "Throughout, [the bill's] patent concern was primarily with the flow of securities from the issuer through underwriters to the public rather than with the subsequent buying and selling of these securities by the public." Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 36 (1959).

In specifically addressing the civil liability provisions of the bill, the House Report explained that Sections 11 and 12 "entitle the buyer of securities sold upon a registration statement" to sue for recovery of the purchase price. *Id.* at 9. Specifically, the report noted:

> The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the prospectus – *the basic information by which the public is solicited.*

Id. (emphasis added).

The House Report explained the provisions of Sections 11 and 12 in some detail. The report noted that placing the burden of proving an exemption from liability on a seller was indispensable with respect to a registration statement or prospectus because "[e]very lawyer knows that with all the facts in the control of the defendant it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of defendant." *Id.*

The report explained that the elimination of the reliance requirement under Sections 11 and 12 was appropriate because the statements made in initial offerings would have wide dissemination and, consequently, would affect the price of the security:

> The statements for which they are responsible, although they may never have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security.

Id. at 10.

The Members who debated the 1933 Act in the House recognized that the 1933 Act would impose civil liability under Section 12(2) only in connection with new issues of securities to the public. Rep. Sabath of Illinois lamented the fact that the House bill did not prevent manipulative transactions in the secondary market. "I had hoped that we would enact a bill at this time that would forever prevent dishonest listings transactions. But unfortunately the committee came to

the conclusion that at this time they could not do it all in one bill." 77 Cong. Rec. 2915 (1933).

Rep. Smith of Washington echoed these sentiments:

> I am in hearty accord with this measure. It will be a forward stride and will protect the American public and buyers of securities. However, it will not reach evils from which the American people have suffered in recent years and from which they are still suffering.
>
> The manipulation of securities after they have been issued embraces and constitutes a greater evil than those arising from the original issue of securities.

Id. at 2941. Finally, Rep. Lambeth of North Carolina said that "while just now we cannot safely deal with securities already before the public nor with corporate management in reference to the investor, there will be another story before long." *Id.* at 2948. *See also id.* at 2919 (stocks already listed on exchanges are not affected by the bill) (remarks of Rep. Rayburn of Texas); *id.* at 2924 (open-market transactions on the exchanges are exempted) (remarks of Rep. Bulwinkle of North Carolina); and *id.* at 2939 (federal authority lapses when the security reaches its "destination, and becomes intermingled in the common mass of property.") (remarks of Rep. Cox of Georgia).

The Senate bill likewise exclusively targeted the initial distribution of securities to the public. The Senate bill contained specific exclusions for "securities which have been issued and are outstanding in the hands of the public prior to the date of the approval of the act" [except securities valued at more than $100,000], and for "isolated transactions." S. Rep. No. 47, 73d Congress, 1st Sess. 4 (1933).

The Senate Report emphasized that these exempted outstanding securities would nevertheless be subject to the criminal penalties and injunctive authority that were eventually framed in Section 17 of the 1933 Act. *Id.* at 4. The Senate bill did not provide that civil remedies under Sections 11 and 12 similarly would be available for existing securities.

After Senate Bill 875 had passed and was in the Conference Committee, Sen. Norbeck of South Dakota explained the

bill's exclusive focus on initial public offerings and its inapplicability to fraud in the secondary market. In discussing the Senate bill, Sen. Norbeck stated that the Senate Committee on Banking and Currency continued to investigate improper conduct in the stock exchanges, but stated: "The pending bill does not in any way deal with the stock exchange. That matter has been left for subsequent and much-needed legislation." 77 Cong. Rec. 3223 (1933).[17]

The conference committee report prepared by the managers for the House detailed the differences between the Senate and House bills and the ultimate resolution of those disputes. The report does not indicate any dispute as to limiting the civil remedies of Section 12 to the public sale of new issues. H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933).[18]

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[17] Sen. Norbeck explained that the Senate bill had three "high points":

> First. That a sworn statement must be filed with the Federal Trade Commission before securities can be offered for sale, and substantial penalties are connected with any violation of the act.
>
> Second. This legislation goes farther than to prevent misrepresentations; it makes it mandatory that the whole truth be told in a signed statement and also in advertisements or any publicity in connection with the sale of securities. It recognizes the fact that a half truth is a falsehood. This will be a new thing in American corporation law; it is in fact copied after the British law.
>
> Third. The directors, underwriters, and issuing houses of the corporation provided for are personally responsible for misrepresentation and may have to answer in court for such misrepresentation.

77 Cong. Rec. 3223 (1933).

[18] Common sense would suggest that if the conference committee had made such a fundamental change as extending Section 12(2)'s civil liability provisions to secondary market transactions, it would have so indicated. As this Court has often noted, Congress's silence in a context such as this is a "dog that did not bark." *See Chisom v. Roemer*, 501 U.S. 380, 111 S. Ct. 2354, 2364 (1991) (quoting Arthur Conan Doyle, *Silver*

Therefore, both the House and Senate bills recognized that Section 12 of the 1933 Act would be limited to new offerings. This understanding is further reflected in the fact that the Senate bill's exclusions for outstanding securities and isolated trades were not included in the 1933 Act. Since there is no indication anywhere that the Senate disagreed with the House bill's restriction of Section 12(2) to newly issued securities, the only explanation for the removal of these exceptions is that they were deemed moot.

IV. CRITICAL POLICY CONSIDERATIONS REQUIRE THAT THE APPLICATION OF SECTION 12(2) BE LIMITED TO INITIAL DISTRIBUTIONS OF SECURITIES.

This Court has repeatedly "acknowledged that 'it is proper for a court to consider . . . policy considerations in construing terms in [the federal securities] Acts.'" *Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 n.7 (1985)). Important policy considerations – including, most significantly, the need for efficient securities markets in which prices reflect all available information regarding securities – dictate that the application of Section 12(2) should be limited to initial distributions of securities.

A. The Application of Section 12(2) to Secondary Market Transactions Will Discourage the Communication of Market Research to the Investing Public.

The potentially devastating impact of applying Section 12(2) to trading in the secondary market is illustrated by contrasting the preparation and role of registration statements for the issuance of securities with the reports prepared by securities analysts after such securities are issued and trading.

Blaze, The Complete Sherlock Holmes 335 (1927)). *See also Church of Scientology v. IRS*, 484 U.S. 9, 17-18 (1987).

Parties involved in the initial distribution of securities to the public routinely engage in an exhaustive "due diligence" process.[19] For example, underwriters of securities (which include many of SIA's members) ordinarily conduct a wide-ranging investigation of the company and its business, including interviewing company officials, contacting customers, inspecting the company's physical operations and working closely with underwriter's counsel and the company's auditors.[20] After the investigation has been completed, the process "may entail numerous drafting sessions at which top management, issuer's counsel, and the investment banker's personnel and counsel meticulously review the registration statement line by line for style, for content, and for compliance with applicable disclosure requirements." 1 H. Bloomenthal, *Going Public and the Public Corporation* § 1.03, at 1-9 to 1-10 (1993). The costs arising from this lengthy and expensive due diligence process are incurred as part of the cost of obtaining access to public capital markets.[21]

This extensive due diligence process is undertaken, in substantial part, because initial distributions of securities are issued to the public by means of a prospectus and therefore clearly subject to Section 12(2). Any party that could be construed to be a "seller" of the securities issued – and therefore potentially liable under Section 12(2) – will necessarily conduct such due diligence in order to establish later, if

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[19] This process typically involves, at a minimum, participation by the company's management, the company's legal counsel, the managing underwriters, the underwriters' legal counsel and the company's independent public accountants, each of which has a separate role in investigating the company and the accuracy of the prospectus. *See* Sonsini, Taylor & Husick, *Who Does What in a Securities Registration*, The Practical Lawyer, vol. 39, no. 8, at 44 (Dec. 1993).

[20] *See* Sonsini, Taylor & Husick, *supra*, at 64-65 (listing 21 steps in due diligence process engaged in by underwriters in two reported cases).

[21] One commentator estimates that out-of-pocket expenses typically incurred in the registration process "are likely to be not less than $250,000 and may be in excess of $1 million . . . ." 1 H. Bloomenthal, *supra*, § 1.03, at 1-9.

necessary, that it met its duty of reasonable care under Section 12(2) to discover any misrepresentations or omissions in the prospectus. The intensity and length of the investigation are a result of the stringent liability standard applied.

By contrast, the process by which securities analysts associated with many of SIA's member firms prepare research reports on publicly traded companies is strikingly different from the registration process described above.[22] Analysts attempt to "ferret out what there is to know about a company from its published information, from what is known about the industry, and what [they] can learn from the company." 1B H. Bloomenthal, *supra*, § 13.11[2], at 13-43 (1993 ed.). As the SEC noted in *In re Dirks*, securities firms use this information in advising their existing or potential clients with respect to the purchase or sale of particular securities.

Unlike the lengthy, exhaustive and expensive registration process, however, the preparation of research reports is necessarily far less detailed and much more rapid. Analysts often prepare reports with partial information regarding the companies they follow. Although analysts can request information from company representatives, company officials have no obligation to provide any information to the analysts, unlike the registration process where management is effectively

[22] The SEC has described the role of such analysts as follows:

> [Securities analysts] are in the business of formulating opinions and insights – not obvious to the general investing public – concerning the attractiveness of particular securities. In the course of their work, analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed.

In re Dirks, Exchange Act Release No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,945 (1981) (footnote omitted), *aff'd*, *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

required to assist in any due diligence investigation.[23] In fact, the registration process constitutes the only comprehensive "snapshot" of a company's condition at a single point in time that most companies ever experience. By contrast, analysts discover incremental bits of information regarding a company over time which evolve into a series of ever-changing research reports.

The sheer number of companies whose securities are publicly traded also necessarily limits the resources to which analysts can devote to any single company.[24] Moreover, in order to provide their customers with the most current information available regarding such companies, analysts typically prepare and issue their reports immediately after discovering any significant information regarding the company.

[23] In connection with a public offering, the management of a company has an enormous incentive to cooperate with a due diligence investigation because the company's ability to obtain the desired financing is contingent upon the completion of such an investigation. After the initial distribution of the company's securities, however, management may have an incentive *not* to assist analysts with their requests for information. Some courts have analogized an encounter between a corporate executive and an analyst to a "fencing match conducted on a tightrope." *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9 (2d Cir. 1977). The dissemination of such research may result in inappropriate comment on the company, *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980), may reduce the price of the company's stock or, in extreme cases such as that in *Dirks*, reveal fraudulent activities by management. *See Dirks*, 463 U.S. at 658 n.18 (describing corporate fraud uncovered by securities analyst).

[24] In 1992, over 2,000 companies were listed on the New York Stock Exchange, over 800 companies were listed on the American Stock Exchange, and over 4,000 companies were listed on NASDAQ. Securities Industry Association, *1993 Securities Industry Fact Book* at 23 (G. Toto & G. Monahan eds. 1993); *The Business One Irwin Investor's Handbook* at 78 (1993); *1993 Nasdaq Fact Book & Company Directory* (1993). The value of outstanding corporate equities in 1992 exceeded $5 trillion, of which almost $4.8 trillion was listed on the New York Stock Exchange, the American Stock Exchange and NASDAQ. *1993 Securities Industry Fact Book*, *supra*, at 21, 23.

Neither the 1933 Act nor the 1934 Act has created a serious statutory impediment to the issuance of such research reports in a prompt fashion and without complete access to corporate information because such reports are recognized as being subject to a "scienter" standard of liability under Rule 10b-5, rather than subject to a negligence standard of liability under Section 12(2). Of course, securities firms have understood that they will be liable under Rule 10b-5 for any misrepresentation or omission in their research reports that is the product of "intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), but that is a league apart from being subject to a negligence standard under which the steps they did or did not take in researching a company would be second-guessed after the fact.[25] Under that statutory framework, securities firms have followed many companies and frequently issued reports on such companies in an expeditious fashion for their customers.

This practice is threatened by a likely "chilling effect" of the rule of law adopted in the decision below. If the term "prospectus" in Section 12(2) is construed to include virtually all written communications, including research reports, securities firms will be extremely circumspect in issuing such reports in the future given their potential liability under Section 12(2) and the burden of defending such claims.[26] It is not hard to imagine that purchasers of securities could claim that

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[25] Under the scienter standard of Rule 10b-5, it is well-established that one cannot show scienter simply by second-guessing a previously made statement with the benefit of "20-20 hindsight" through, what several courts have called, "Monday morning quarterbacking." *See, e.g. In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 556 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994); *In re Apple Computer Sec. Litig.*, 672 F. Supp. 1552, 1564 (N.D. Cal. 1987), *aff'd in part and rev'd in part*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). By contrast, the essence of any negligence standard of liability is an analysis in hindsight of a party's actions.

[26] *Cf. New York Times Co. v. Sullivan*, 376 U.S. 254, 279 (1964) (holding that placing burden of establishing truth of contested statements on libel defendants causes "self-censorship" of truthful speech because

a research report contained a material misrepresentation or omission, which under Section 12(2) would impose the burden on the securities firm of showing that it "did not know, and in the exercise of reasonable care could not have known" of the misrepresentation or omission.

In order to ensure that they will be able to establish a Section 12(2) defense, securities firms would be required, if possible, to investigate every conceivable fact regarding a company in a fashion much like the process currently undertaken with respect to registration statements and prospectuses.[27] As a practical matter, such an investigation may not be possible since the company's management is under no obligation to provide information in response to an analyst's inquiries and may actually have an incentive not to cooperate with analysts.

Moreover, research reports issued subject to Section 12(2) would not be issued as promptly as they currently are. If such reports were subject to Section 12(2), their issuance would be delayed while a registration-like "line-by-line" review was undertaken. The communication of important new

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speakers will be deterred from speaking by risk of liability and burden of defending such claims). *New York Times Co* requires public official libel plaintiffs to establish "actual malice" – that is, that the speaker acted with "knowledge that [the statement] was false or with reckless disregard of whether it was false or not" – which serves a gatekeeper function with respect to such actions and promotes the flow of information to the public. *Id.* at 279-80. Applying the intent-based "scienter" requirement of Rule 10b-5 to research reports – rather than the negligence standard of Section 12(2) – also serves as a gatekeeper with respect to claims by investors and, similarly, promotes the flow of information to the marketplace.

[27] Ironically, such a rule would impose a higher burden of investigation with respect to research reports issued by securities firms than that currently imposed by Congress and the SEC on publicly traded companies with respect to their annual and quarterly reports and other public filings. *See* Section 18 of the 1934 Act, 15 U.S.C. § 78r (1988).

information about companies to the investing public would thus be delayed, if not precluded.[28]

Given the enormous potential liability under Section 12(2) that would arise from even an innocently made error, securities firms would have to weigh that considerable risk in deciding whether to issue such reports at all. For many such firms and for many issuers,[29] the risk would likely outweigh the benefit of such reports for securities firms in meeting the needs of their customers for information and advice.[30] The result would likely be less complete and less current information for investors, and less access to capital markets for new companies.

[28] Indeed, if research reports were subject to Section 12(2), a securities firm could even be liable for a typographical error negligently made in a report, as illustrated in *Ballay*, 925 F.2d 682. *Ballay* involved, among other things, a claim that a research report mistakenly stated that the value for a company's stock *excluded* goodwill, when the value in fact *included* goodwill. 925 F.2d at 686. In the absence of an intent to deceive, manipulate or defraud, the securities firm would have had no liability under Rule 10b-5 for such a negligent mistake, as the jury in fact determined in *Ballay*. *Id.* Under Section 12(2), however, the firm could be subject to rescissionary damages with respect to a secondary market transaction in which it received, at most, a commission for particular isolated sales. Because Section 12(2) does not require a showing of either reliance or causation, the firm could be liable not only to purchasers who in fact relied upon the language containing the typographical error, but also to purchasers who never even saw that report.

[29] It is likely that smaller capitalized companies – which have relatively fewer shareholders and less trading in their shares – would be the first to lose research coverage under such a regime since there will generally be less demand for research regarding them.

[30] *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976) (Establishing a negligence standard under Rule 10b-5 would raise "serious policy questions not yet addressed by Congress.")

B. A Decline in the Communication of Market Research to the Investing Public Will Interfere with the Efficient Operation of Capital Markets.

Securities markets thrive on information. This Court has acknowledged that Congress relied upon this fundamental premise in enacting the federal securities laws and has noted that "empirical studies have tended to confirm Congress's premise that the market price of shares traded on well-developed markets reflects all publicly available information . . . . " *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988).

Because they increase the amount of publicly available information regarding companies, securities analysts play a crucial role in the efficient operation of the market for securities.[31] In view of this important function played by analysts, the SEC has expressed concerns about "discourag[ing] analysts from engaging in the legitimate and desirable function of seeking out corporate information." *In re Dirks*, Exchange Act Release No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,947 (1981), *aff'd*, *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

This Court – in commenting upon the role the research analyst played in uncovering fraud in *Dirks* – also recognized the important role that analysts play in "the preservation of a healthy market." *Dirks*, 463 U.S. at 658. Although analysts do not routinely discover widespread fraud by corporations, their research indisputably brings more complete information to the trading market, which allows market prices to reflect that

[31] As the SEC itself has explained:

> The value to the entire market of these efforts [by securities analysts] cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.

In re Dirks, Exchange Act Release No. 17480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,945 (1981) (footnote omitted), *aff'd*, *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983).

information, and draws capital into the market by allowing investors to trade with confidence that their judgment is based on solid information.[32]

As discussed above, the application of Section 12(2) to securities analysts' research reports will reduce the availability and timeliness of such reports to the investing public, thus impeding the efficient operation of capital markets. As a policy matter, Section 12(2) should not be interpreted to produce that result.

C. Policy Considerations Dictate that Section 12(2) Not Be Applied to Privately Negotiated Sales of Securities.

Important policy considerations also counsel against applying Section 12(2) to privately negotiated sales of stock, such as the transaction at issue in the case below.[33] Treating a privately negotiated stock purchase agreement as a "prospectus" for purposes of Section 12(2) would impose an amorphous federal negligence standard on the due diligence investigation undertaken for such transactions, a matter that is currently subject to negotiation between the parties. Such a mandatory federal standard would require the seller, and the

[32] The SEC and the exchanges have long encouraged corporations to hold meetings with analysts in order to serve the important function of collecting, evaluating and disseminating corporate information for public use. *Elkind, supra*, 635 F.2d at 165. Commentators have also recognized the importance of independent corporate research to the proper functioning of the capital markets. *See, e.g.*, Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 341 (1979); Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 Hofstra L. Rev. 127, 130 (1984).

[33] Privately negotiated stock transactions typically involve sophisticated parties who are in a position to bargain for the protections desired. A purchaser in such a transaction will undertake extensive due diligence and commonly will base its decisions entirely on its own evaluation of the business. Fishman, *Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. Corp. L. 251, 256-57 (1987).

seller's agents, to investigate every aspect of the business, even when the buyer has no interest whatsoever in the result of that investigation or would prefer to undertake the investigation itself. As such, the application of Section 12(2) to such a transaction would simply increase transaction costs by imposing a "deadweight" loss on the parties.

The stock purchase at issue in the decision below is an example of such a transaction.[34] Respondents, with the assistance of professional advisers, negotiated to acquire stock from petitioners pursuant to an extensively negotiated stock purchase agreement. In the agreement, the parties carefully delineated the representations and warranties made by the sellers. The transaction closed only after respondents had an opportunity to conduct a due diligence investigation with complete access to the company's books and records, employees and physical facilities. *Gustafson v. Alloyd Co., Inc.*, Petition for Writ of Certiorari at 4-7.

The decision below – which remanded in light of the *Pacific Dunlop* determination that a privately negotiated stock purchase agreement is a "prospectus" within the meaning of Section 12(2) – reallocates the burden of investigation in an inefficient fashion. The parties' arms-length agreement provided specific representations, warranties and limitations of remedies and granted respondents complete access to the company's books and records to conduct their own investigation. If respondents desired further representations and warranties from the sellers regarding the business of the company, they could have negotiated for such contractual protection by offering additional consideration to petitioners.

[34] Respondents assert that Section 12(2) should be applied to their purchase of the stock of Alloyd Co., Inc., because the stock purchase took on the characteristics of a new offering of securities to the public. *Gustafson v. Alloyd Co., Inc.*, No. 93-404, Brief of Respondents In Opposition to Petition for a Writ of Certiorari at 8. Respondents' stock purchase had none of the attributes of an initial distribution of securities to the public. In order to take on the characteristics of an initial distribution of securities to the public, a secondary market transaction, at a minimum, would require an offering of the security to the public.

Presumably for sound economic reasons, they chose not to do so.

Applying Section 12(2) to such a transaction between sophisticated parties bargaining at arms-length imposes a mandatory federal standard that supersedes the parties' ability to allocate contractually the duty of investigation.[35] If sellers in such transactions face potential Section 12(2) liability, they effectively will be required to engage in a due diligence investigation of the company so that they may later show that "in the exercise of reasonable care [they] could not have known" of any misrepresentations or omissions. This is so even if the purchaser prefers to conduct its own due diligence rather than rely on the seller's representations. Requiring a seller to bear that burden will increase transaction costs unnecessarily. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Lawyer 1, 32 (1992).

Indeed, the application of Section 12(2) to privately negotiated stock purchase agreements would likely lead to investigations by sellers and their agents with respect to matters that are of no interest to buyers.[36] The inefficiency of such a rule of law is evident on its face.[37] Without such a mandatory federal standard, the parties are able to investigate, and negotiate for representations with respect to, only the aspects of the business that are truly of interest to the buyer.

[35] The parties could not agree contractually that Section 12(2) would not apply to the transaction. 15 U.S.C. § 77n (1988).

[36] For instance, a purchaser may be concerned about only a portion of the acquired corporation's business or operations and may attempt to obtain protection, in the form of contractual representations and warranties, on only this aspect of the business. Fishman, *Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. Corp. L. 251, 257 n.38 (1987).

[37] *See* Fishman, *supra*, 12 J. Corp. L. at 323 (concluding that placing duty of disclosure on seller in a privately negotiated stock transaction inefficiently increases transaction costs insofar as it requires an investigation of aspects of the business by the seller that is not valued by either party).

Application of Section 12(2) to such private transactions thus would increase the costs of transactions and disrupt the delicate balance of privately negotiated agreements. Balanced against this burden is the fact that truly defrauded parties have a more than adequate remedy under Rule 10b-5 if the other party to the transaction in fact acted with intent to deceive, manipulate or defraud. Given that adequate legal protection already exists for truly defrauded parties,[38] policy considerations dictate that Section 12(2) not be applied to privately negotiated stock transactions when such a liability rule simply would increase the costs of transactions and limit the ability of parties to reach binding private agreements regarding the burden of investigation and risk.[39]

[38] Of course, injured parties may also have state common law remedies. Here, respondents asserted a claim for breach of the stock purchase agreement.

[39] Justice Stevens generally recognized these policy considerations in *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 700 (1985) (Stevens, J., dissenting) ("There is no suggestion that the buyers were unable to obtain appropriate warranties or to insist on the exchange and independent evaluation of relevant financial information before entering into the transactions."). In *Landreth*, the Court relied upon "the plain meaning" of the definition of "security" in Section 2(1) of the 1933 Act in holding that stock transferred pursuant to a private stock purchase agreement fell within that definition. *Id.* at 687. In this case, by contrast, the plain meaning of the definition of "prospectus" in Section 2(10) does *not* encompass private stock purchase agreements, *see* § I *supra*, and thus the policy rationale recognized by Justice Stevens should apply with full force in this context. Here, the plain meaning of "prospectus" is fully supportive of the result that sound policy also dictates.

CONCLUSION

For the foregoing reasons, SIA respectfully requests that the Court reverse the decision below and hold that liability under Section 12(2) of the Securities Act of 1933 is limited to initial distributions of securities to the public.

Respectfully submitted,

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APPENDIX

Section 12(2) of the 1933 Act, 15 U.S.C. § 771 (1988):

Any person who –

* * *

> (2) offers or sells a security (whether or not exempted by the provisions of section 77c [section 3] of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 17 of the 1933 Act, 15 U.S.C. § 77q (1988):

(a) It shall be unlawfull for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly –

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicly to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.